

**TO:** MII MANAGERS  
**FROM:** DEGELIS TUFTS  
**SUBJECT:** SHORT POSITION – KRAFT FOODS  
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<b>Financial Information</b>			<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
		<i>(\$ bn)</i>				
Share Price	\$32.42					
Shares Outst.	1.64 bn	<b>Revenues</b>	34.35	34.11	32.17	30.5
Market Cap	\$53.13 bn	<i>% Change</i>	0.7%	6.0%	5.5%	4.3%
Enterprise Value	\$63.70 bn					
52-week range	\$29-36.67	<b>EBITDA</b>	4.53	4.75	4.6	6
Float	205.97 m	<i>% Change</i>	-4.6%	3.3%	-23.3%	0.7%
Short Interest	47.73 m					
Long-Term Debt	\$10.21 bn	<b>EPS</b>	1.86	1.72	1.56	1.96
Ave 10-day Volume	41 m	<i>% Change</i>	8.1%	10.3%	-20.4%	3.2%
Price/Earnings	17.73x					
Return on Assets	5.80%					
Return on Equity	10.53%					
Cash (MRQ)	\$239 m					
Cash Flow (Op)	\$3.72 bn					

## **BUSINESS DESCRIPTION**

Kraft Foods, Inc. is engaged in the manufacture and sale of packaged foods and beverages with operations in 72 countries, and sells its products in 155 countries. It operates in two segments: Kraft North America and Kraft International. Its packaged food products include beverages, cheese, snacks, convenient meals and packaged grocery items. Some commonly recognizable brands that Kraft owns are Oreo, Maxwell House, Oscar Meyer, Ritz, Nabisco, Philadelphia, Post Cereals, Stove Top and Tang.

Kraft restructured its operations in several ways over the last 2 years. In 2006, it cut 13% of its workforce and closed 39 plants, and fired CEO Betsy Holden for poor performance. In January 2007, it divested its hot cereal segment and trademarks. On the other hand, in December 2006 it had acquired all Nabisco trademarks in Europe, the Middle East and Africa, along with the Spanish and Portuguese operations of United Biscuit. In March 2007, the Altria Group completed the spin-off of Kraft to its shareholders, distributing 89% of Kraft's outstanding shares. Because of the spin-off, Kraft is an independent public company.

## **MANAGEMENT OVERVIEW**

Irene B. Rosenfeld became Chief Executive Officer of Kraft Foods in June 2006. Rosenfeld has worked in the food industry since 1981 when she began working for General Foods as a Market Research Manager. She has extensive experience in the Kraft North America division and served as its President for 3 years. Among her accomplishments at Kraft, she led the integration of the Nabisco acquisition, and served on the senior team that led Kraft's IPO in 2001.

Despite her far-reaching knowledge of the North American food market, Ms. Rosenfeld has less experience with most foreign markets. Other members of the management team may compensate this, such as the Chairman Ajay Banga (since 2007), who is CEO of Citigroup's Global Consumer Group. Between 1981-1996, Mr. Banga worked for Nestle, and also for PepsiCo in its restaurants division. He was instrumental in the launch of Pizza Hut and KFC in India.

In addition, Kraft announced on April 13, 2007 that its Chief Marketing Officer, Jeri Finard, is leaving the company for personal reasons after just six months on the job. Ms. Finard has worked for Kraft for two decades and until last year was the Executive VP of Global Category Development.

In a recent presentation, Ms. Rosenfeld regretfully admitted that Kraft has an overly bureaucratic structure and that management has been uncomfortable speaking up about changes they feel are necessary. She also explained that, despite Kraft's global footprint, too many operating decisions are made from headquarters in the US, when local managers who are familiar with the markets should have more power.

## **INDUSTRY POSITION**

Currently, the food and food services industry is unattractive as private label brands steal market share from the major players. This is mainly because price increases are hurting sales growth in a wide range of food categories. In addition, health and trans-fat concerns have adversely affected sales and image for companies selling processed foods.

Kraft underperforms the food group in sales growth, market share trends and the ability to protect price premiums. However, Kraft already spends more than the food group average on brand support (high ad/sales). In recent years, Kraft has brought prices close to private label. This is not an effective strategy to solidify franchise strength, and it has forced Kraft to reduce brand support, innovation, and sometimes hurt product quality. Private label brands continue to eat into its market share despite price decreases.

## **INVESTMENT OVERVIEW**

In summary, I believe that the MII should short Kraft stock for the following reasons:

- Below average industry growth, falling market share and falling margins
- Management problems
- Cost-cutting program is unrealistic and hurts product quality, marketing and innovation

- Long-term restructuring solution, not expecting to reach financial targets for several years
- Product recalls coupled with health concerns hurts brand image
- Difficulties succeeding in foreign markets

## **INVESTMENT THESIS**

### **(I) Below average industry growth coupled with decreasing sales figures in key segments**

Kraft has grown its revenue by -3.02% (MRQ), which is well below the food industry average of 6.11%. It also has negative EPS growth of -18.20%, while the average industry EPS growth is 27.39% (source: Ameritrade). In addition, it is currently losing market share in Cereal, Cookies, Crackers, Natural and Processed Cheeses, Coffee, and Snack/Granola bars, while it is only gaining market share in Lunchmeats and Dinner Mixes. Loss in market share reflects poor sales execution, loss of voice in the market, and a need for relevant products. CEO Irene Rosenfeld admits that, “We have been apologizing for our [product] categories instead of reinventing them.”

Kraft’s portfolio is structurally disadvantaged, with operations skewed toward commodity products (with little price flexibility) in developed markets in North America with lower growth rates than emerging markets. In addition, its international growth strategy is hampered in several ways (see below). Restructuring will take time and most likely further hurt EPS before improving it.

In a February 2007 presentation, the Ms. Rosenfeld outlined a plan of “measured change.” However, Kraft needs to strengthen emerging markets positions, exit or spin-off underperforming components, and invest in high growth categories such as organic or ethnic foods. Kraft is not recognizing these bold measures as short-term priorities. Management also outlines a plan to recover premiums through increased brand equity and improve product mix by offering a wider range of price points and making acquisitions. However, similar products simply offered at different price points can prove cannibalistic and not necessarily accretive to margins. In addition, these plans take time and money.

### **(II) Difficult to cut costs without sacrificing quality**

Kraft’s current cost-cutting program will take significant time to implement and includes \$500 million more in costs and trade spending adjustments. However, Kraft needs to bulk up its innovation pipeline before it cuts costs. It opts for cost cutting instead of risking new product development, a strategy that is ineffective and hurts quality.

In the past, one way Kraft tried to cut costs was through warehousing delivery. Although direct-store delivery is more expensive, it provides in-store presence that strengthens relationships with retailers. This is one example of how Kraft’s minimization of sales and marketing costs has hurt their operations.

In addition, many input prices of Kraft's products are commoditized. Margins have recently suffered as costs have risen for everything from ingredients to fuel for processing, packaging and distribution. Therefore, it is highly unlikely that the company can fund future investment in turnarounds through cost reductions. There is in fact a possibility that commodity costs, especially in dairy and meats, will increase and not be passed along to prices.

Many of Kraft's brands are currently "stuck in the middle." A recent article from *The Economist* explains that Kraft could find more opportunities by moving up-market. It cites Maxwell House as a good example of a brand stuck in mid-market compared to Starbucks, and ridicules its low quality Singles Cheese and Miracle Whip brands that private labels can imitate: "Anybody can pre-slice cheese and put it in plastic." Kraft misses opportunities by avoiding risky investments that would result in premium products.

### **(III) Kraft does not expect to reach financial targets before 2008 (MS)**

It is not until 2009 that the company expects to achieve the financial targets it has outlined, namely at least 4% revenue growth and 7-9% EPS growth. Given recent results, 2009 may even be too optimistic. Any recent increases in the stock price have been driven by management's promises to investors that it will make acquisitions in fast-growing emerging markets categories. However, international growth lags behind competitors and the company admits that realistically its growth objectives (which are STILL below the industry average) will take several years to carry out.

### **(IV) Product recalls, along with health concerns, hurts sales and brand image**

In February of 2007, Kraft recalled all of its *Oscar Meyer/Louis Rich* Chicken Strips and Cuts products as a safety precaution due to a finding of *Listeria Monocytogenes* bacteria. In addition, this year, they faced charges due to a peanut butter recall. These prove that Kraft must strengthen their processing controls and programs and those of their co-manufacturers. Since Kraft is a household name, an image of safety is extremely important, and incidences such as these may adversely effect on brand loyalty.

In addition, the US Food and Drug Administration have been emphasizing the detrimental health effects of trans-fats and ingredients in certain packaged foods. Since a large portion of Kraft's products is pre-packaged meals and snacks, this campaign has had an effect on brand image and sales.

### **(V) Kraft's credit metrics are expected to weaken due to share repurchase**

As of April 12<sup>th</sup>, Moody's cut Kraft's debt due to the company's plan to repurchase \$5 billion in shares. Kraft's credit metrics are expected to significantly weaken due to the repurchase. In addition, any benefit on EPS of the share repurchase has already been incorporated into the future EPS outlook for the company, which still lags behind the industry.

## **(VI) Kraft fails to exploit its scale to execute strategy in foreign markets**

Despite Kraft's enormous size and resources, it has limited presence in foreign and developing markets. It fails to use its scale and scope to steal market leadership from local brands. In addition, it often misreads market needs and trends in foreign countries, indicating the need for in-depth market research prior to product launches. Its quality of food in foreign markets is also criticized. For example, its version of Guacamole is less than 2% fruit, and they have received complaints and even a lawsuit for fraud. A pasty mix of food starch and corn syrup is barely the way to capture part of the \$18 billion dollar (and growing) Latin food industry. In addition, it faces regulatory and international risks in countries such as China, where the media and regulators are currently fixated on the transgressions of foreign firms. KFC is currently under attack, and Kraft has suffered bad publicity there (as well as Heinz, Nestle and Haagen-Dazs).

**Conclusion: There is no “quick-fix” to Kraft’s issues, which span the globe and many of its product categories. This fact was corroborated by recent financial results as well as projections.**

## **RISKS: WHY THE STOCK PRICE COULD GO UP**

- Strong positions in the U.S. – 73% of sales come from #1 positions
- Kraft's issues could already be reflected in the current stock discount (traded at lower P/E compared to industry). There is room for Kraft to start trading in-line with the food group. However, there is speculation of a resistance ceiling since many Kraft shareholders are looking to recover their losses and exit their positions in the event of a price rally.
- Currently trendy brands could lead to revenue increases in the US. For example, Kraft plans to grow its line of South Beach Diet meals, to offer deli-counter meats instead of pre-packaged products, to market its DiGiornio and CPK brand pizzas more effectively, and to offer “Deli Creations” and “Fresh Creations” as restaurant quality on-the-go sandwich and salad options.

## 1-YEAR STOCK CHART



## VALUE- ADDED RESEARCH

- (I) Visits to Spanish supermarkets during my study abroad experience
- (II) Reading about Kraft's international woes through publications such as *The Economist*
  - a. "Hold the Avocado: Guacamole gets a Gringo Makeover" – December 2006
  - b. "Stuck in the Middle" – January 2007
  - c. "Time to get Krafty" – February 2007
- (III) Listened to Irene Rosenfeld's 1-hour Speech on February 20<sup>th</sup> pertaining to the future of Kraft's operations
  - a. Webcast can be found at: <HTTP://PHX.CORPORATE-IR.NET/PHOENIX.ZHTML?P=IROL-EVENTDETAILS&C=129070&EVENTID=1421651>
- (IV) Wall Street Research Analysts to corroborate my ideas
  - a. Pablo Zuanic, JPMorgan Food and Food Manufacture Research
    - 212-622-6744
  - b. David Adelman, Morgan Stanley Research
    - 212-761-6382

## **IDEAS FOR MII**

I have been attending MII meetings since the fall of my first year, and have seen the many ways it has evolved and improved over the past 3 years. The website is now fully functional, additional roles have been created (which complements attendance growth), and awareness about the club has increased significantly through campus marketing techniques. The number of first years at meetings has grown exponentially, creating a solid membership base. Despite these changes, there is always room for improvement. As I have not been able to attend meetings this semester while I am abroad, I will do my best to use the knowledge I have of the club to make several recommendations. The following pertain to portfolio strategy, interaction among members, profit allocation, the website, fundraising and elections.

### **(I) The MII Portfolio**

I think that our portfolio should be more actively managed. Although we take positions based on the long-term potential of companies, there are times when fundamental analysis may be wrong and the investment theses do not pan out. As a result, we sometimes have underperformers in our portfolio for longer than they should be. In conclusion, managers should request follow-up analysis from members if positions need re-evaluation.

### **(II) Profit Allocation**

Over the last several years, the MII donated generous amounts to the McIntire School of Commerce. I am so enthusiastic about this club because we can pursue our interests while simultaneously giving back to the University. Therefore, I think that in the future MII has the potential to be even more creative with how it uses its profits in order to pursue this ideal while taking advantage of public relations opportunities at the same time. For example, it could sponsor major Comm School events or guest speakers. In this way, the club could combine marketing itself with community involvement. Another idea is to donate to selected Charlottesville charity organizations. The amounts would not have to be large, and donations could help to foster good relations between UVA and the Charlottesville community.

### **(III) Management and member interaction**

I think that MII should take additional measures to foster interaction between younger and older members of the club. As newcomers, first- or second- years are entering with a pair of fresh eyes, and may have some useful input or recommendations. They also may want to get involved and do not know where to start. In addition, pre- or non- commerce students may not understand certain concepts discussed during presentations. Despite these questions and concerns, members may not always feel comfortable approaching senior members of the club or asking simple questions during meetings. I know that this issue has been brought up in the past, but I do not believe it is entirely resolved. Simple measures can be taken in order to improve it. For example, managers could announce at the end of the meetings that they will stay after to personally answer questions. I also think that analysts who are presenting should leave their email addresses on the board so that people who did not get a chance or did not feel comfortable asking a question could approach them later.

#### **(IV) Website Blog**

In the past, I have heard the idea tossed around of a blog on the MII website, and I would like to elaborate on this further. MII members are generally very enthusiastic about investing and should be able to share ideas or ask each other questions. However, our meetings are more didactic in nature, opposed to interactive. An online blog would act as a forum, allowing members to easily share investment ideas. There are many analysts who have ideas but may not have the time to present them, and there are also members who would like to present but need company ideas. A blog would be a way to match demand with supply.

#### **(V) Fundraising**

Most UVA alums that I speak to about MII think that it is an absolutely great idea for a club, but had not known about it previously. I think that if we could raise awareness among our alumni network – specifically ex-MII members, McIntire alums or any alums working in finance – we could raise money through donations in order to increase our funds under management. This would have to be a carefully designed and presented campaign, but may be a way to significantly increase the number of presentations each semester that the managers can realistically consider.

#### **(VI) Elections**

I think that investment memos for elections (such as these) should be sent out to the club before elections, since officers that are running spend a lot of time working on them but have a very small time allotted to present them. In this way, members can read more about them on their own if they are interested and ask better questions.